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Address by
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Comptroller General of the United States
before the
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The Federal Budget, the Economy
and Inflation

We live in a world where everything is related to and affected by everything else. This is becoming increasingly apparent on domestic and international fronts.

In no area, perhaps, is the existence of interrelationships and interactions more apparent or more important than in our very complex economy. Many have studied these interrelationships and interactions in an attempt to discover useful rules by which to judge and present state of affairs, to predict future events, and to help influence those future events for the overall good of our society. The rules which have been developed are not perfect and their application remains more an art than a science; but they have been useful in helping us to understand the dynamics of the economy and ways to react when unforeseen events cause us particular economic problems.

A very powerful influence on our nation's economy is, of course, the Federal budget--nearly 10 percent of the Gross National Product. Conversely, the general state of the economy influences the Federal budget in several important ways.

Through changes in revenue and expenditure levels in the Federal budget, substantial changes can be effected in aggregate demand, price levels, and employment. Selective changes in the incidence of

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taxes, tax expenditures, and spending, can be used to significantly affect various sectors of the economy vis a vis the others. That the Federal budget constitutes an important tool for influencing the economy--a proposition popularized by John Maynard Keynes--is not in doubt. The controversy that remains is over measurement of the effects and judgmental questions relating to the appropriate types, magnitude and timing of budgetary actions to stimulate or stabilize the economy.

The total performance of the economy, on the other hand, significantly affects both Federal revenues and spending. Rising production and employment bring increased revenues to the Treasury and automatically tend to reduce Federal spending in some areas. These tend to restrain rapid expansion and its inflationary effects. Alternatively, if the economy slumps and levels of business and employment fall, so do Federal revenues. At the same time, the burden of unemployment increases demands on the Treasury for unemployment insurance benefits, public assistance in various forms including food stamps, and public service employment, as well as other types of spending, and tax expenditures to bolster the economy. Hopefully, the deficit these cause will provide impetus to the economy, leading to its recovery.

Our present recession will lead us this coming year to a deficit larger by far than any on record.

The current situation is complicated rather markedly by our recent experience with double-digit inflation and continuing rising price levels at rates with which we are not very comfortable. Let me review some of the events that led up to our present problems in this regard.

In the early 1960's inflation was in the neighborhood of 1 to 2 percent per year. In general, the "creeping inflation" of those years appeared to be of little concern to policymakers. Later in the decade, the inflation pace increased under the impetus of Vietnam war spending. The big jump in Government spending would have been bad enough, but the inflationary impact was heightened by an underestimation of the budgetary costs of the war, a reluctance to increase taxes to cover these costs, and strong consumer demands for goods and services in the private sector.

The second big jolt to prices occurred during 1973 and 1974. A considerable part of the jolt was due to cost-push factors--commodity shortages and the emergence of the oil producing export countries cartel. The higher oil prices, incidentally, had a peculiar economic impact. Not only did the higher prices act to increase the cost of living but also, because the extra billions of dollars spent on oil were sent abroad, the effect was very much like a tax whose revenues were set aside and not returned to the economy. This was a very definite contributing factor to the current recession.

These events have left us in a situation where the Consumer Price Index had increased by 58 percent since 1967 and by about 28 percent in the last two years. Inflation, by itself, has led to large increases in the cost of Government purchases of goods and services in recent years and to large increases in transfer payments which are indexed to the Consumer Price Index.

We currently face something of a dilemma in that the demands for deficit spending to bolster the economy generally and provide income for the unemployed will tend to exert continued upward pressures on price levels.

Budgetary reform

The vast and complex set of interrelationships between the Federal budget and the economy, generally coupled with the equally complex set of political processes through which this nation assesses national needs and priorities and devises means for meeting them, makes the job of fashioning an overall Federal budget in a fiscally responsible way a complex and difficult one indeed. And it is a job which becomes more complex and difficult as our economy becomes more complex.

Until 1921 the formulation of the Federal budget was carried out largely on a piecemeal basis, with each department and agency submitting its budget requests and legislative proposals directly to the Congress for consideration and action without any central overview within the executive branch on behalf of the President.

The Budget and Accounting Act of 1921 changed this by creating the Bureau of the Budget--first located in the Treasury Department

and later in the Executive Office of the President--to assist the President in formulating an overall budget consistent with his views of national needs and priorities, including those relevant to the economy. Incidentally, that same act created the General Accounting Office which I head and about which I will say a few things later.

The machinery created by this legislation, and now managed by the Office of Management and Budget in the Executive Office of the President, greatly facilitated the Government's ability to "look at the big picture," so to speak, and to set objectives and priorities within an overall framework and constraints deemed, at least by the President and some of his advisors to be fiscally responsible.

This budget set a baseline for congressional consideration and action, during which executive branch judgments and recommendations were examined and questioned. Changes were recommended through a system of committees and subcommittees, and ultimately a budget was enacted.

This system worked relatively well for a long time. Congressional action on the budget, however, was still accomplished on a piecemeal basis with numerous revenue, authorization and appropriation bills being considered by separate subcommittees and committees of both Houses and finally coming up for floor action in the two Houses.

As the budget grew larger and more complex, with room for greater divergence of judgment on national objectives and priorities and the means to achieve them, the system became more and more cumbersome and less and less likely to produce a budget which was properly balanced with the functioning of the overall economy.

One concern was that over the past 25 years the appropriations committees gradually lost jurisdiction over a large portion of total outlays. This happened because more and more legislation was enacted which resulted in entitlements such as veterans' pensions, welfare payments, subsidies, and a host of other activities which were largely removed from effective control through the appropriations committees. About all that the appropriations committees could do was to ratify obligations already made. The result was that each of the legislative committees became appropriations committees to the point where the House and Senate appropriations committees' jurisdiction covered less than half of total Federal outlays.

Long delays occurred in the enactment of many parts of the budget. Often appropriations were not enacted before the start of the fiscal year, requiring resort to the expedient of continuing resolutions to keep major parts of the Government functioning.

Appropriation bills submitted for the President's approval were often vetoed because he did not consider them to be in reasonable consonance with his overall budget and the needs of the economy. Vetoes resulted in further delay and controversy; in at least one case, as a result of delays and vetoes, the huge Department of Health, Education, and Welfare ran on continuing resolutions throughout a full fiscal year and well into the next without any appropriation act becoming law.

Even when the President signed appropriation acts, it did not always end the matter. Where he deemed it prudent, the President deferred or prohibited the use of appropriated funds--the so called impoundments--raising constitutional questions concerning the separation of powers and generating considerable litigation.

Not only was this process disrupting to the functioning of the Federal Government, the delays and uncertainties in a sector which is so central to the Nation, but was disconcerting to the whole Nation in a social and economic sense as well as a political one.

The situation prompted the Congress to recognize that it must update and modernize its process for enacting the Federal budget into law and to do so in a way which insures that each part of the budget is considered an integral part of the whole. It needed a mechanism through which each part of the budget could be justified, not only on its own merits but in its relationships to the overall impact of the budget on our social and economic well-being.

Such a process established by the Congressional Budget and Impoundment Control act and enacted a year ago next month, is relatively simple.

It lays down a strict and rather tight timetable for the completion of all legislative actions required for formulating and enacting the overall budget before the start of a fiscal year.

It requires that the Congress, early in each session, reach a judgment, articulated through a concurrent resolution, on the overall budgetary picture, including both revenues and outlays with allocations by revenue source and major functional categories of the budget.

It also requires that all legislative actions either be consistent with the overall constraints spelled out in the first concurrent resolution or that the concurrent resolution be revised to accommodate judgments on the overall budget.

The legislation created a budget committee in each house of the Congress to serve as the focal point for looking at the budget in its entirety. Also created was a Congressional Budget Office to assist not only the Budget Committees but the Appropriations, Ways and Means, and Finance Committees, and other Committees as well.

The new legislation requires 5-year forecasts of revenues, cost estimates for proposed legislation that is reported to the floor, and cost projections for all existing legislation. The Budget Committees must set an overall spending level dictated by stabilization goals, and spending on the various programs must be reconciled under this limit.

The fiscal year will be changed to October through September, with a transitional budget to cover the 3 months between June 30 of that year when fiscal year 1976 closes and October 1, 1976, when, under the new system, fiscal year 1977 starts.

As I mentioned earlier, the timetable for the steps leading to the enactment of the overall budget is very tight. The key steps and the dates by which they must be taken are:

November 10 of preceding year--President submits a "current Services budget" which is essentially a budget carrying forward all current activities without change.

15th day after Congress meets--President submits his budget.

March 15--Committees and Joint Committees report to the Budget Committee their views and recommendations on matters falling within their respective jurisdictions.

April 1--Congressional Budget Office submits its overall report to the Budget Committee, providing analyses of various alternatives.

April 15--Budget Committees report the first concurrent resolution to their respective Houses.

May 15--Other Committees report bills and resolutions authorizing new budget authority.

May 15--Congress completes action on the first concurrent resolution.

7th day after Labor Day--Congress completes action on all bills and resolutions providing new budget authority.

Sept. 15--Congress completes action on second required concurrent resolution.

Sept. 25- - Congress completes action on a reconciliation bill or resolution implementing the second concurrent resolution. This bill or resolution adjusts the details of the budget to conform to the second concurrent resolution.

Oct. 1--Fiscal year begins.

As I said, the process is simple in concept, but it will take the concerted efforts of many to implement the process effectively. With such a major change in the process of handling the budget, it should be no great surprise that the machinery will not work entirely smoothly the first time around, or perhaps even the second time around. The concern is whether there will be sufficient patience with the new process to enable this readjustment to take place and to give the new process a full opportunity to test itself. But I am personally encouraged by the prospects.

This year the Congress is making kind of a dry run of the process so that full implementation next year will be facilitated. So far it has gone quite well. The first concurrent resolution, passed last month, calls for a deficit of about \$69 billion, up \$17 billion from that shown in the President's budget submitted in February.

You may, of course, choose to agree or disagree with the level of the budget deficit, either the one proposed by the President, the one incorporated into the first concurrent resolution last month, or the one which will finally emerge at the completion of the budget formulation process. There is no perfect answer. But for the first time there is a target, set by the Congress, against which it may judge the aggregate of its legislative actions.

The new process is one which hopefully will let the best judgments on budget priorities rise to the surface, within a frame-work which deals with the budget and the relationship of it and its various components to the overall economy in a cohesive and comprehensive manner.

I have already alluded to the complex set of political processes through which this Nation assesses national needs and priorities and devises means for meeting them. Unfortunately, but necessarily, the new congressional budget process adds to this. It not only adds the budget committees each having a jurisdiction as broad as that of the Government itself, but adds new actors or expands the role of old actors on the scene.

Besides the budget committees and their staffs, the one principal new actor is the Congressional Budget Office. It has a major role to play in the system, principally by providing analyses of the effects of alternative levels of budget authority and revenues, and alternative allocations of these among various governmental purposes, on our societal condition, including the economy. The law specifically states that this new office, in its report to the Budget Committees due on or before each April 1st, discuss "national budget priorities, including alternative ways of allocating budget authority and budget outlays among major programs or functional categories, taking into account how such alternative allocations will meet major national needs and affect balanced growth and development of the United States."

This function--offering clear choices together with their implications for the nation's welfare, to the Budget Committees as well as others--is an extremely important one.

Other parts of the act enlarge upon the role of other congressional agencies, including the General Accounting Office. In essence, each of these agencies, with its own focus, is to act cooperatively with the others, to produce for the Congress the best information base possible for its decisionmaking.

The Congressional Research Service of the Library of Congress draws mainly upon published literature to provide informational needs of the Congress. The new law makes it clear that the Service should support the informational needs of the Congressional Budget Office as well as the new budget committees and the other congressional committees.

The relatively new Office of Technology Assessment is likewise expected to serve these needs. This Office is charged with considering principally the long term effects and implications of the development and implementation of new and emerging technologies as well as considering the effects of technology already in use. It was intended to serve as an "early warning" tool against possible ill effects of scientific advances--in both the hard and soft services.

GAO was given both these general responsibilities--to support the budget committees and cooperate with the Congressional Budget Office--and certain specific responsibilities under the act.

From its inception in 1921, our charter has been extremely broad. We were told to "investigate at the seat of Government and elsewhere, all matters relating to the receipt, disbursement, and application of public funds," and to make recommendations for the greater economy and efficiency of Government.

Our activities under this broad charter have evolved steadily over time, and at an increasing rate in more recent years.

From a modest beginning of being concerned principally with the fiscal accountability of the Federal Government--that is, that funds and property were prudently safeguarded and used only for purposes authorized by law-- We have developed and pursued at least two additional types of accountability-- management accountability, concerned with whether resources are used efficiently toward their intended purpose, and program accountability, concerned with the extent to which programs achieve their intended objectives and with whether alternatives are available to meet these objectives more effectively or efficiently.

Each one of these is, of course, important for the proper and effective functioning of the Federal establishment. The studies undertaken in each area can be drawn upon by each of the congressional committees and agencies in the performance of their particular function.

In addition, the new law expands upon the responsibilities of the GAO, both as laid on in its initial 1921 charter and in subsequent legislation, particularly the Legislative Reorganization Act of 1970.

Under this legislation, we are responsible for assisting congressional committees in developing statements of legislation goals and methods of assessing program performance against such goals. We are charged with cooperating with the Office of Management and Budget and the Treasury Department in developing, establishing, and maintaining a standardized information system which will meet the needs not only of the Congress but also of the executive branch generally and insofar as practicable, of the State and local levels of Government.

We are also responsible for developing standard terminology definitions, classifications and codes for Federal fiscal, budgetary, and program-related data and information.

Finally, we are responsible for reviewing and for advising the Congress, and related activities, when the President chooses to either defer or rescind the use of budget authority enacted in legislation.

We will continue our traditional efforts to improve the effectiveness of Government in general and we will embrace our new responsibilities under the new legislation to the same end.

Before closing, I will mention just a couple of examples of issues which will be subject to specific analyses in an effort to gain a better understanding of the relationship of the Federal budget to the overall economy.

First, let's consider the relationship between inflation and income taxes. Personal income taxes, which are the largest single source of Federal revenue, are influenced dramatically by inflation. A person whose income increases right along with inflation naturally has to pay higher taxes. But if he compares his current tax rate to what it was a few years ago, he will be in for an unpleasant surprise--his taxes as a percentage of total income will have increased because of our progressive tax system. The person's higher income pushes him into a higher tax bracket. Even if, by our assumption, his income increased enough to offset inflation, his real disposable income will have fallen, because taxes are taking a bigger piece of it.

What is the actual magnitude of this effect? According to an estimate by the Joint Committee on Internal Revenue Taxation, income tax revenues increased by \$7 billion because inflation pushed people into higher tax brackets.

Inflation also distorts the corporate income tax. If a firm uses the first-in, first-out method of accounting, then inflation makes it appear that the real value of the firm's inventories has increased whereas, in fact, they may only have kept pace with inflation. Also, depreciation costs are understated, because they are calculated against the original cost, rather than the inflated replacement cost, of the capital equipment. For both of these reasons, profits are overstated and the firm winds up paying higher corporate profit taxes, even though the value of its profits in real terms may not have increased. In order to compensate for this effect, among other things, quite a number of firms are switching from first-in, first-out to last-in, first-out. There are several other ways in which inflation affects the corporate profit and loss statements, and very little is known about the magnitudes of the resulting changes in tax liabilities.

Next, let's consider the relationship between inflation and Federal spending levels. As inflation proceeds, the government naturally has to spend more on the goods and services that it purchases. In addition, transfer payments, such as social security, inevitably grow.

Most of these transfer payments grow automatically because, by law, they are linked to the Consumer Price Index or to some other indicator of the cost of living. This is called "indexing."

The list of indexed retirement programs now includes social security, civil service, railroad workers, armed forces, and the foreign service. In addition, food stamps, school lunch and breakfast, and aid to the aged, blind, and disabled are all tied to a price index.

The point of indexing is to keep the value of these benefits constant despite inflation, without Congress constantly having to revise the legislation. Whether indexing results in higher or lower spending is a debatable point. Some, looking at the effect that inflation has had, would say that spending on these programs is "out of control." Others would say that the indexing has preserved the original intent of Congress and that if Congress were to constantly revise the legislation spending might be even higher than it is now.

Whatever the pros and cons of indexing, it is certainly true that inflation has greatly increased the budgetary cost of these programs. More than 70 million people benefit from some type of indexed program, and in the 1976 budget indexing alone will lead to an increase in spending of \$3.8 billion.

Incidentally, the portion of wage earners and pensioners in the private sector whose income is indexed to the CPI is considerably smaller although it is growing and will probably grow still further in the future as long as the high rates of inflation continue.

With consequences of this magnitude, indexing becomes as important in the budget as many specific programs. Therefore, it is important to gain as good an understanding as possible of the effects of indexing on the overall economy; it may be that indexing, if practiced too widely, may itself exert inflationary pressure on the economy.

These and other issues will be pursued by us as well as by others in an effort to improve the understanding of the implications of alternative courses of action in the overall budgetary process.

To conclude on a somewhat more optimistic note, there are signs that the current recession has run its course. At least there seems to be an emerging consensus among forecasters that recovery will begin in the next several months.

Most recoveries in the postwar era involve growth in the 8 to 9 percent range during the first 5 quarters following the trough of a recession. Most econometric forecasters have concluded that recovery this time will progress more slowly, perhaps at a 6 to 7 percent growth rate. Two weeks ago, for example, the Administration issued its Mid-Session Review of the 1976 budget. In this report, they assume that the recovery from the current recession will begin shortly and that real growth in the economy will be close to 6 percent for 1976.

The forecast that appeared in the Mid-Session Review offers a dramatically different scenario for the recovery than was presented in the President's budget only last February. There he forecast a continuation of high rates of both unemployment and inflation. Unemployment was projected at an average of 8.1 percent for 1975 and the rate of inflation was predicted to be in excess of 11 percent. (The current unemployment rate is 9.2 percent and the inflation rate is approximately 8 percent.)

The original projections by the Administration were, we believe, based on two crucial assumptions: (1) that the phenomena of stagflation with relatively high levels of unemployment and double-digit inflation, would continue to haunt the economy and (2) that the President's energy bill would be enacted early in the 94th Congress. Later events have demonstrated that those assumptions were not valid. Therefore, it appears

that the higher unemployment now being experienced will lower the rate of inflation more than was expected several months ago.

Recent economic events indicate that the current recession has taken on some of the characteristics of a "normal" recession; that is, the rate at which prices increase slows down as the unemployment rate increases. Stagflation may not be totally and permanently gone, but the unemployment-inflation tradeoff analysis is more applicable now than it was during 1974, when a large portion of the inflation was due to higher energy prices.

Although there is a consensus that recovery will begin in the next several months, there is a great deal of uncertainty as to its trend. This uncertainty is based upon analysis of the major sectors of the economy. None of these sectors appears to be shaping up as the "Moses sector;" that is, the one that will lead the economy out of the recession. Traditionally, the housing and auto industries have had this role, but prospects in this area are still most uncertain despite the recent positive signals in housing permits and starts. During the course of the summer, more data will become available that will provide some insights as to the shape of the anticipated recovery. This data will also provide, hopefully, an indication of the fiscal impact of the Tax Reduction Act of 1975 and whether the tax rebates have provided a major stimulus to the economy.

Our present economic situation, and I am certain those which will emerge in the future, and the well-being of our society in general, challenge each of us, in Government and out, to do our best to make our Government as effective as possible in articulating, as rationally and effectively as possible, a budgetary policy which meets national needs and priorities

in the best possible way. The answers will never be perfect, but with all our best efforts, and with the better mechanism for congressional decisionmaking on the budget and its relationships with our economy, the answers arrived at will be better answers and will improve in the years ahead.

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Sunday, June 22

10:45 a.m. - lv. residence

12:00 noon - lv. Washington Dulles via TW 99 (Lunch)

2:17 p.m. - ar. Los Angeles (Mr. Hall will meet you and drive you to his home) (Tel: (213) 986-4909)

4:00 p.m. - Cocktail/Buffer at Mr. Hall's residence
(Assistant Regional Managers and wives will also attend)

- Drive to Anaheim; reservation at Disneyland Hotel
(Tel: (714) 535-8171)

Monday, June 23

National Association of Accountants's Annual
International Conference, Anaheim Convention Center

(Tel: (714) 533-5536)

8:00 a.m. - Speakers' Breakfast
(Anaheim Convention Center - Orange 10 Room)

9:15 a.m. - Meet with Mr. Hall and staff (Disneyland Hotel)

12:00 noon - Reception)
) Anaheim Convention Center
12:30 p.m. - NAA Keynote Luncheon) Orange County Room
)
3:15 p.m. - Speech)

- Drive to Los Angeles; reservation at Valley Hilton Hotel
15433 Ventura Boulevard
(Tel: (213) 981-5400)

Tuesday, June 24

9:00 a.m. - lv. Los Angeles via UNITED 52 (Lunch)
(someone will drive you to airport)

4:50 p.m. - ar. Washington Dulles

6:30 p.m. - Guests of Deputy Ambassador of Germany Hansen and Mrs. Hansen
for dinner and ballet (JFKennedy Center) Black Tie